FAIR POLITICAL PRACTICES COMMISSION

Memorandum

To: Chairman Randolph and Commissioners Blair, Downey, Karlan and Knox

From: Jill Stecher, Commission Counsel
John W. Wallace, Assistant General Counsel
Luisa Menchaca, General Counsel

Date: December 1, 2003

Re: Adoption of Amendments to Regulation 18707.5
Sources of Income to Owners of Retail Business Entities

I. EXECUTIVE SUMMARY

Government Code section 87103.5 sets forth an exception whereby a retail customer of a business entity is not considered a source of income to a public official/business owner if certain criteria are met. Regulation 18707.5 implements this section by defining these criteria. Last year, the Legislature amended Government Code section 87103.5 by adding a new statutory definition of "significant segment" applicable only to retail businesses located in small jurisdictions. Therefore, regulation 18707.5 is presented for amendment to incorporate the 2002 statutory provisions for small jurisdictions and to make other technical conforming and clarifying changes. On November 17, 2003, the Governor issued Executive Order S-2-03 delaying action on proposed regulations and directing agencies of the Executive Branch to reassess various aspects of the State's rulemaking process. Adoption of this regulation may be delayed pending a determination of the impact of the order, if any, on the Fair Political Practices Commission, an independent agency subject to the 1974 Administrative Procedure Act. The major changes include:

1) A codified definition of "significant segment" as applied to a "jurisdiction with a population of 10,000 or less which is located in a county with 350 or fewer retail businesses." (Section 87103.5(b).) The proposed amended regulation now incorporates this and sets forth definitions for both small and large jurisdictions.

2) A codified income standard for small jurisdictions based on income received by the business entity from a retail customer "12 months prior to the time the decision is made." (Section 87103.5(b).) The current regulation uses a fiscal year time standard. Based on the Commission's decision from the October 2003 meeting, the proposed amended regulation uses the 12-month time standard for both small and large jurisdictions.

II. OVERVIEW OF THE LAW

The conflict-of-interest provisions of the Political Reform Act (the "Act")[1] prohibit a public official from making, participating in making or using his or her official position to influence a governmental decision in which he or she has a financial interest (section 87100, regulation 18700). An economic interest includes, among other things, a source of income of $500 or more promised to or received by a public official within 12 months prior to the time a governmental decision is made. (Section 87103(c).)

Accordingly, a retail customer, who has paid or promised $500 or more (within 12 months prior to a governmental decision) to a retail business entity in which a public official owns a 10-percent or greater interest, may be considered a source of income to the public official. If the business owner/public official's pro rata share of the income from an individual customer of the business equals or exceeds $500 over the 12-month period preceding his or her participation in a governmental decision, the customer is an economic interest of the official. (Section 87103(c).)

However, pursuant to section 87103.5, added in 1984 (Stats. 1984, Ch. 931),[2]and regulation 18703.5 (renumbered later as regulation 18707.5), implementing that section, retail customers of a business entity are not considered sources of income to a public official owning 10 percent or more of a business entity which engages in retail sales of goods or services to the public, if: (1) the retail customers comprise a significant segment of the public generally, and (2) the amount of income received by the business entity from the customer is not distinguishable from the amount of income received from the entity's other retail customers.

Subdivision (a) below shows the substance of the statute as first enacted:

> "(a) Notwithstanding subdivision (c) of Section 87103, a retail customer of a business entity engaged in retail sales of goods or services to the public generally is not a source of income to an official who owns a 10-percent or greater interest in the entity if the retail customers of the business entity constitute a significant segment of the public generally, and the amount of income received by the business entity from the customer is not distinguishable from the amount of income received from its other retail customers."

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[1] Government Code sections 81000-91014. Commission regulations appear at Title 2, sections 18109-18997, of the California Code of Regulations. All statutory references are to the Government Code unless otherwise indicated.

[2] In 1984, the Commission was approached by the League of California Cities (the "League") to sponsor legislation addressing a source of income disqualification issue concerning retail business owners in small jurisdictions. The League was concerned that owners of retail business entities in small, rural jurisdictions had difficulty serving as public officials because nearly everyone in town was a customer and, consequently, a source of income which could lead to potential disqualification for the public official. The League proposed that legislation be introduced to create an exception for this situation. The theory was that where the individual customer was not distinguishable from every other customer, the likelihood of favoritism towards such sources of income was substantially reduced.

Government Code section 87103.5 was amended in 2002[3] to add subdivisions (b) and (c), as follows:

> "(b) Notwithstanding subdivision (c) of Section 87103, in a jurisdiction with a population of 10,000 or less which is located in a county with 350 or fewer retail businesses, a retail customer of a business entity engaged in retail sales of goods or services to the public generally is not a source of income to an official of that jurisdiction who owns a 10-percent or greater interest in the entity, if the retail customers of the business entity constitute a significant segment of the public generally, and the amount of income received by the business entity from the customer does not exceed one percent of the gross sales revenues that the business entity earned during the 12 months prior to the time the decision is made.
> "(c) For the purposes of subdivision (b):
> (1) Population in a jurisdiction shall be established by the United States Census.
> (2) The number of retail businesses in a county shall be established by the previous quarter's Covered Employment and Wages Report (ES-202) of the Labor Market Information Division of the California Employment Development Department."

The new statute establishes a special, more lenient rule for small jurisdictions. The new provisions define a small jurisdiction as one "with a population of 10,000 or less which is located in a county with 350 or fewer retail businesses." For a small jurisdiction, the statute also expressly states that the amount of income received by the retail business entity from a customer is "not distinguishable" from the amount of income received from other retail customers if it does "not exceed one percent of the gross sales revenues that the business entity earned during the 12 months prior to the time the decision is made." (Section 87103.5(b).) Regulation 18707.5 is presented for amendment and adoption because the 2002 statutory amendments necessitate incorporating the new provisions for small jurisdictions.

III. REGULATION 18707.5

As noted above, section 87103.5 sets forth two criteria which must be met in order for a customer of a retail business to be excluded as both an economic interest and a possible basis for disqualification to the owner/public official:

1) "…the retail customers of the business entity constitute a significant segment of the public generally, and

[3] The Commission opposed Assembly Bill 2366, amending Government Code section 87103.5, on the grounds that it did not further the purposes of the Act because it significantly increased the amount of retail sales income a public official in a small jurisdiction could receive and still be allowed to vote/participate in a decision involving that source of income.

2) "the amount of income received by the business entity from the customer is not distinguishable from the amount of income received from its other retail customers."[4] (Section 87103.5(a).)

Section 87103.5 did not define what constitutes a "significant segment of the public generally" or when income from a customer is considered "not distinguishable" from the amount of income received from other retail customers of the business. Therefore, the Commission adopted a regulation to define these terms.

The regulation originally set forth criteria for what constitutes a "significant segment of the public generally." It also defined a customer of a retail business entity and gave the owner/public official guidelines for "knowing" when a decision will affect a source of income to the retail business entity. Finally, the regulation expressly defined when the amount of income received by a business entity from a retail customer was not distinguishable from the amount of income received from its other retail customers. No distinction was required for small versus large jurisdictions.

A. Discussion of Regulation 18707.5

New section 87103.5(b) created a distinction between jurisdictions by defining a small jurisdiction as one "with a population of 10,000 or less which is located in a county with 350 or fewer retail businesses." The criteria under section 87103.5(a) is now limited to large jurisdictions.

Proposed amendments to existing regulation 18707.5 reflect the two-step process of the original regulation, as follows:

- **subdivision (a)**: **Significant Segment Test**
  sets forth the standards used to determine when the retail customers of a business entity constitute a "significant segment" of the public generally, and is divided into (a)(1) large jurisdictional provisions, and (a)(2) small jurisdictional provisions.

- **subdivision (b): Indistinguishable Income Test**
  sets forth the standards used to determine when income received from a retail customer is "not distinguishable" from income received from other retail customers, and is also divided into (b)(1) large jurisdictional income standards, and (b)(2) small jurisdictional income standards.

Subdivision (a): "Significant Segment Test"

Subdivision (a)(1)

By virtue of the new statutory language dealing specifically with small jurisdictions, regulation 18707.5, subdivisions (a)(1)(A) and (B), now apply only to a "jurisdiction with a

[4] Although the statute was not expressly limited to small jurisdictions, the factors were more often met in small jurisdictions.

population of more than 10,000 or which is located in a county with more than 350 retail businesses." The new language merely clarifies this jurisdictional size standard. This jurisdictional size standard is the opposite of the amended statute's definition of "small jurisdiction," at subdivision (a)(2) of the amended regulation.

<u>Subdivision (a)(2)</u>

Proposed amended regulation 18707.5(a)(2) contains new language that has been added to codify the definition of "significant segment" pursuant to new section 87103.5(b) as applied to a "jurisdiction with a population of 10,000 or less which is located in a county with 350 or fewer retail businesses."

The test for what constitutes a "significant segment" is identical to the test in subdivision (a)(1)(A), applied to large jurisdictions. However, since the criterion in (a)(1)(B), that "[t]he retail customers of the business entity during the preceding 12 months number at least ten thousand," is based on a population that exceeds that of the small jurisdiction, it cannot be used as a test for "significant segment" in subdivision (a)(2) and is not included.

<u>Subdivision (b): "Indistinguishable Income Test"</u>

Subdivision (b) sets forth the standards used to determine whether income received from a retail customer is distinguishable from income received from other retail customers.

<u>Subdivision (b)(1)</u>

Similar to subdivision (a)(1), identical clarifying language has been added to subdivision (b)(1) that applies to a large jurisdiction "with a population of more than 10,000 or which is located in a county with more than 350 retail businesses."

Currently, for large jurisdictions with a population of more than 10,000 or more than 350 retail businesses, the standard to determine whether income received from a retail customer is distinguishable from that received from other retail customers, is as follows:

> "… the amount of income received by a business entity from a retail customer is not distinguishable from the amount of income received from its other retail customers if the amount spent by the customer in question during the preceding 12 months is less than one-tenth of 1 percent of the gross sales revenues of the retail business entity for the preceding *fiscal year.*"[5] (Emphasis added.)

[5] Note that this standard for income is only articulated in the regulation; it is not set forth in the statute.

Subdivision (b)(2)

New section 87103.5(b) sets forth the size of a small jurisdiction and an income standard specifically for small jurisdictions. Articulated within the statute itself, the income standard is:

> "… the amount of income received by the business entity from the customer does not exceed one percent of the gross sales revenues that the business entity earned during the *12 months prior to the time the decision is made.*" (Emphasis added.)

Accordingly, the same statutory income standard is used for small jurisdictions in proposed subdivision (b)(2) of the regulation.

B. October 2, 2003 Commission Meeting: Prenotice Discussion of Regulation 18707.5 Amendments

Implementing the statutory change of section 87103.5(b) raised the question of *whether there should be two different time standards in the regulation, one using a fiscal year (applicable to large jurisdictions) and one using 12 months preceding a decision (applicable to small jurisdictions).* Since the revised statute explicitly sets forth the 12-month standard for small jurisdictions (now proposed in subdivision (b)(2)), amending subdivision (b)(1) to use the same 12-month standard for large jurisdictions would add consistency. With this change, the parallel test in subdivisions (b)(1) and (b)(2) would only differ as to the percentage of money spent by the customer over the same measurement of time, i.e., *during the 12 months prior to the time the decision is made.*

At its October 2003 meeting, the Commission decided that the same 12-month standard should be used consistently for both subdivisions (b)(1) and (b)(2) of the regulation. This decision was based primarily upon the new statutory language. Therefore, the proposed amendment to subdivision (b)(1) uses the original percentage of gross sales revenues, but parallels the standard of "12 months prior to the time the decision is made." (Page 2, lines 12-13.)

A secondary issue was raised as to whether regulation 18707.5 should be in Step 3 rather than in Step 7 of the eight-step conflict-of-interest analysis. Under Step 3, an official's economic interests are identified; Step 7 determines if the "public generally" exception applies. The placement of regulation 18707.5 within the eight-step conflict-of-interest analysis does not affect the statutory changes in section 87103.5 or the proposed amendments to this regulation. Staff did not recommend changing the placement of the regulation and Chairman Randolph supported leaving the regulation at Step 7.

Other minor changes have been made, including grammatical changes or conforming subdivision number changes.

IV. STAFF RECOMMENDATION

Staff recommends that the Commission adopt the proposed amendments to regulation 18707.5 to implement statutory changes.

Attachment - Proposed regulation 18707.5

Legal:Jstecher:adopt18707.5.doc